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No. 142

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

AMERICAN SURETY COMPANY OF NEW YORK,
A CORPORATION,
Petitioner,

vs.

PAUL W. SAMPSELL, AS TRUSTEE IN BANKRUPTCY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONER

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Respondent makes several arguments in his brief which, although fully met by the materials set forth in petitioner's opening brief, may for the convenience of the Court be answered as follows:

1. The question presented is not the nature of equitable distribution in bankruptcy-suretyship cases, but whether there was any surety relationship upon which exercise of the rule of equitable distribution could be predicated by the bankruptcy court.

Half of respondent's brief (pp. 1-6) is devoted to a discussion of the authorities respecting equitable distribution of the bankrupt estate, which preclude a surety from sharing in distribution until the secured general creditors have been made whole. Petitioner's opening brief assumes this state of the law (pp. 17-19), but contests its applicability in a situation where—as here—an inchoate surety relationship was extinguished under governing state law prior to the institution of bankruptcy proceedings. That is the question presented (Pet. Br. 2) as respondent admits (Resp. Br. 8). Petitioner does not, as respondent suggests (Resp. Br. 2), attempt to limit the rule of equitable distribution—because no such rule is applicable in this case in any respect. The authorities cited in respondent's brief (pp. 1-6) are inapplicable to the question here presented because in no one of them was there any question as to the existence under state or federal law of the necessary, valid, and subsisting surety relationship. Recognizing that there is such a question in this case, the remainder of respondent's brief is devoted to the attempt to show that there was an existing surety relationship.

2. Respondent's assertion that the Constitution of California breathes life into a surety relationship otherwise dead under the California statutes and decisions is untenable both (1) because the cited provision of the California Constitution does not apply to bonds and (2) because the California courts hold that this provision of the California Constitution is not operative apart from the California statutes.

In attempting to show that there was an existing surety relationship during the bankruptcy proceedings, respondent opens his argument with the statement that the California Constitution itself protects laborers and mater-

ialmen. But the cited provision (Art. XX §15, Resp. Br. 7) has no relation whatever to bonds and suretyship but, instead, provides for a lien "upon the property upon which they have bestowed labor or furnished material." If that provision has any effect apart from legislation, it is operative not against the bankrupt contractor or his surety but against the General Electric Company which owns the factory property upon which the alterations were made and for which labor and materials were furnished.

Furthermore, whatever its effect may be apart from legislation, the California courts hold that the constitutional provision is not self-operative. In *Spinney v. Griffith*, 98 Cal. 149, 32 P. 974, the Supreme Court of California holds that the constitutional

> declaration of a right *** is inoperative except as supplemented by legislative action.
>
> So far as substantial benefits are concerned, the naked right without the interposition of the legislature is like the earth before the creation, "without form and void", or to put it in the usual form, the constitution in this respect is not self-executing. [pp. 151-152.]
>
> The "lien law" is with us preeminently a creature of statute. [p. 153.]
>
> The lien *** is the creation of statute ***. We must look to the source of its being, the statute, alike for the right to such a lien and the mode by which it can be secured.

To the same effect see *Ferger v. Gearhart*, 44 Cal. App. 245, 247, 186 P. 376, which involved the statutory requirement that a lien be filed within the time provided by the statute. "The right to the lien is purely statutory." *McLaughlin v. Perkins*, 102 Cal. 502, 506, 36 P. 839 (involving the statutory requirement of filing within 30 days). Respondent is therefore in error in stating (Br. 7) that the right of lien arises from the Constitution itself.

Respondent also takes issue (Br. 8-10) with petitioner's statement (Br. 8) that under California law the bond is substituted for the liability of the property. But it is obvious on the face of the California statutes that a substitution is precisely what occurs and the Supreme Court of California so treats the situation. *Roystone Co. v. Darling*, 171 Cal. 526, 542, 154 P. 15.

Similarly respondent is in error in stating that the lien-bond statutes merely supply the means of enforcement (Br. 8, 12). The *Spinney* and other California cases cited above unequivocally hold that the right of laborers and materialmen is wholly the creature of statute in every respect. "The actual right of lien, as well as the remedy for its enforcement, is derived from the statute ***". *Bailey etc. Iron Co. v. Goldschmidt*, 33 Cal. App. 661, 663, 166 P. 363. To be sure, the so-called mechanics' lien statutes of California are "remedial in character" in the sense that thereby laborers and materialmen may have security for their claims over and above their ordinary right of action, but the failure to follow the statute and comply with requirements in all substantial respects such as the filing of liens within the time provided is fatal to the existence of such security rights. *Hammond Lumber Co. v. Barth Invest. Corp.*, 202 Cal. 601. Respondent (Br. 8) cites *Cutler-Hammond, Inc v. Wayne*, 101 F. 2d 823; but there the Circuit Court of Appeals for the Fifth Circuit was avowedly dealing with "liens in good standing when bankruptcy comes".

In connection with respondent's argument that the mechanics' lien statutes of California are merely procedural, the statement is made—apparently by way of analogy—that statutes of limitations do not go to the merits of a claim but "merely affect the enforcement of certain remedies" (Resp. Br. 12). However, the California statutes expressly provide (§ 2911, Civil Code) that "a lien is extinguished by the lapse of time within which,

under the provisions of the Code of Civil Procedure, "* * * an action can be brought upon the principal obligation." Absent such a provision, or if it is inapplicable to remedies under bonds as distinguished from liens proper, the state law of limitations would nevertheless apply in federal bankruptcy proceedings where the bankruptcy law—as here—does not modify the situation or create a new right. *Harrigan v. Bergdoll*, 270 U.S. 560, 564. (Of course the issue in this case is not whether the state statute of limitations has run, but whether an indispensable element of the right of laborers or materialmen to security—that is, the requisite filing of lien or notice to the surety—is lacking.)

3. Respondent's argument that the bond alone determines its coverage and the rights of laborers or materialmen is contrary to the applicable law of California.

Throughout his brief (pp. 6, 8, 9, 10, 11-12) and contrary to his argument that the California Constitution governs (see point 2 *supra*), respondent either vigorously argues or assumes that the coverage of, and rights under, the bond here involved are to be determined solely upon the face of the bond. The law of California is otherwise, as fully set forth in petitioner's opening brief (p. 10). "The terms of the statute are read into the bond and control its interpretation and effect." *Carpenter v. National Surety Co.*, 25 Cal. App. 2d 90, 93, 76 P. 2d 523. Since these bonds are forms customarily used, if respondent's point were well taken the courts of California could not arrive at decisions requiring compliance with the statutes.

4. Respondent's argument that a reversal of the judgment would give petitioner surety some undue advantage or be a "detriment" to general claimants is untenable in fact and law.

Respondent argues that, had the three unpaid laborers and materialmen filed their claims, the surety would "have

been liable for a much larger amount" than it actually paid out under the bond (Resp. Br. 13). It is true that, had they filed their claims or given the statutory notice to the surety, they might have collected $1,336.11 from the surety (R. 35-36, 91-92). They neglected to perfect their rights and no one now contends that they could still do so apart from the present bankruptcy proceedings. As reasons for giving them the surety's share of the bankrupt estate, respondent now makes three arguments:

First, respondent suggests that the surety was paid for what it did (Resp. Br. 13). But part of the suretyship was a right of subrogation. The amount of the premium paid to petitioner was fixed with that in mind. Moreover, sureties know that they will not in any event be made whole because bankrupt estates do not pay 100% on each dollar of claim. In this case, despite respondent's assertions to the contrary (Resp. Br. 9-10, 13), petitioner had no security from its principal (R. 55).

Second, respondent argues that the surety (pursuant to its acknowledged right of subrogation) seeks to participate in the estate of the bankrupt "on a parity" with the unpaid laborers and materialmen (Resp. Br. 13). But if it should do so, the situation is the same as if there had been no surety bond—because the surety merely stands in the shoes of the other laborers and materialmen who, but for having perfected their rights under the bond and mechanics' lien statutes, would be seeking in the same dollar amount to share in the estate "on a parity" with the unpaid laborers and materialmen. Since respondent can show no present privity with or perfected right to the suretyship pursuant to which the other laborers and materialmen were paid in full, it cannot now complain that the surety shares equally in the bankrupt estate in substitution for those whom it has paid. If the unsecured laborers and materialmen can make such an argument validly, then

any other unpaid and unsecured claimant can as meritoriously make the same objection to the claims of all sureties in any bankruptcy cases.

Third, respondent insists that the surety can be permitted to share equally in the bankrupt estate only "to the detriment" of unpaid laborers and materialmen (Resp. Br. 13). But the surety's participation in the distribution is no more a "detriment" to them than it is to the other unsecured general creditors. The supposed detriment is to be avoided, if at all, only upon some valid and existing surety relationship between petitioner and the unpaid laborers and materialmen. But the sole point of this case is that there was no surety relationship when the bankruptcy proceedings were initiated and none was lawfully created or assumed thereafter.

As stated in petitioner's opening brief (pp. 19-20) the issue here is whether there shall be due recognition of the dignity and applicability of state statutes in causes which happen to be pending in federal tribunals, at least where federal statutes make no contrary provision. The California law here involved is statutory, and there are no California decisions in derogation of those statutes. Section 4 of the California Code of Civil Procedure expressly provides that

> The code establishes the law of this state respecting the subjects to which it relates ***.

The issue is whether federal courts may, as did the courts below, substitute their judgment as to the existence and enforcement of right arising by virtue of local law despite the unequivocal state of that law to the contrary and in the absence of direction by federal statute. Although respondent asserts in his second caption that "the federal court gave due recognition to the applicability of state statutes" (Resp. Br. 7), the court below frankly took the position that its decision "was governed by Federal law,

not State law" (R. 130). Respondent has not met that issue and, for the reasons stated in petitioner's opening brief, the judgment below should be reversed.

Respectfully submitted,

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